No. 5955

In the United States Circuit Court of Appeals for the Ninth Circuit

Joseph O. Koepfli, Roland P. Bishop and William T. Bishop, petitioners

v.

Commissioner of Internal Revenue, respondent

UPON PETITION TO REVIEW AN ORDER OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR RESPONDENT

G. A. YOUNGQUIST,
Assistant Attorney General.

SEWALL KEY,
HELEN R. CARLOSS,
Special Assistants to the Attorney General.

C. M. CHAREST,
General Counsel, Bureau of Internal Revenue,
DEWITT M. EVANS,
Special Attorney, Bureau of Internal Revenue,
Of Counsel.

FILED
APR 1 - 1930
PAUL P. O'BRIEN,
CLERK

INDEX

	Page
Previous opinion	1
Jurisdiction	1
Question presented	2
Statutes and regulations involved	2
Statement of facts	4
Summary of argument	6
Argument:	
I. In determining the gain realized in 1922 on the sale of property acquired prior to March 1, 1913, when the basis is cost, proper adjustment of the cost should be made for depreciation sustained between the date of acquisition and March 1, 1913	8
II. The legislative history of the enactment of Section 202 (b) (1) of the Revenue Act of 1921 does not show that in enacting that provision Congress intended that no adjustment for depreciation sustained prior to March 1, 1913, should be made in the cost basis	21
Conclusion	29

CITATIONS

Cases:

Even Realty Co., Appeal of, 1 B. T. A. 355	14
Goodrich v. *Edwards*, 255 U. S. 527	11, 18, 23
Heiner v. *Tindle*, 276 U. S. 582	17
Johnson v. *Southern Pacific Co.*, 196 U. S. 1	29
Lucas v. *Alexander*, 279 U. S. 573	18
McCaughn v. *Ludington*, 268 U. S. 106	18
Merchants' L. & T. Co. v. *Smietanka*, 255 U. S. 509	11, 23
Maryland Casualty Co. v. *United States*, 251 U. S. 342	20
National Lead Co. v. *United States*, 252 U. S. 140	20
Noaker Ice Cream Co. v. *Commissioner*, 9 B. T. A. 1100	14, 17
United States v. *Flannery*, 268 U. S. 98	18
United States v. *Ludey*, 274 U. S. 295	6, 11
United States v. *Mitchell*, 271 U. S. 295	17
United States v. *Phez Co.*, 28 F. (2d) 106	28
Walsh v. *Brewster*, 255 U. S. 536	11, 18, 23

Statutes:

	Page
Revenue Act of 1916, c. 463, 39 Stat. 736—	
Sec. 2 (c)	21
Revenue Act of 1918, c. 18, 40 Stat. 1057—	
Sec. 202	22
Revenue Act of 1921, c. 136, 42 Stat. 227—	
Sec. 202	2
Sec. 213 (a)	3
Revenue Act of 1924, c. 234, 43 Stat. 253—	
Sec. 202	25
Revenue Act of 1926, c. 27, 44 Stat. 9—	
Sec. 202	27

Miscellaneous:

A. R. R. 6930, C. B. III–1, p. 45	20
H. R. 350, 67th Cong., 1st sess., p. 9	23
H. R. 179, 68th Cong., 1st sess., p. 12	25
H. R. 1, 69th Cong., 1st sess. pp. 5–6	26
I. T. 1494, C. B. I–2, p. 19	20
S. R. 275, 67th Cong., 1st sess., p. 10	23
S. R. 52, 69th Cong., 1st sess., pp. 15–16	26
T. D. 3206, C. B. 5, p. 51	20, 24
Treasury Department Regulations 62:	
Art. 1561	3

In the United States Circuit Court of Appeals for the Ninth Circuit

No. 5955

JOSEPH O. KOEPFLI, ROLAND P. BISHOP AND WILLIAM T. BISHOP, petitioners
v.
COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

UPON PETITION TO REVIEW AN ORDER OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR RESPONDENT

PREVIOUS OPINION

The only previous opinion in the present case is that of the United States Board of Tax Appeals (R. 40-42), which is reported in 13 B. T. A. 784.

JURISDICTION

The petition for review involves income taxes for the year 1922 and is taken from orders of redetermination of the United States Board of Tax Appeals entered on December 17, 1928. (R. 42-45.) This case is brought to this court by petition for

review filed June 17, 1929 (R. 47–56), pursuant to Sections 1001, 1002, and 1003 of the Revenue Act of 1926, c. 27, 44 Stat. 9, 109, 110.

QUESTION PRESENTED

In determining the gain in 1922 on the sale of property acquired prior to March 1, 1913, when the basis is cost or March 1, 1913, value, whichever is greater, is it required under Section 202 (b) of the Revenue Act of 1921 that the cost basis be reduced by depreciation accrued or sustained prior to March 1, 1913?

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1921, c. 136, 42 Stat. 227:

> SEC. 202. (a) That the basis for ascertaining the gain derived or loss sustained from a sale or other disposition of property, real, personal, or mixed, acquired after February 28, 1913, shall be the cost of such property; * * *.
>
> (b) The basis for ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March 1, 1913, shall be the same as that provided by subdivision (a); but
>
> (1) If its fair market price or value as of March 1, 1913, is in excess of such basis, the gain to be included in the gross income shall be the excess of the amount realized therefor over such fair market price or value; * * *.

Sec. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—

(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

Regulations 62, Treasury Department:

Art. 1561. *Basis for determining gain or loss from sale.*—For the purpose of ascertaining the gain or loss from the sale or exchange of property, the basis is the cost of such property, or in the case of property which should be included in the inventory, its latest inventory value. But in the case of property acquired before March 1, 1913, when its fair market value as of that date is in excess of its cost, the gain to be included in gross income is the excess of the amount realized therefor over such fair market value. Also in the case of property acquired before March 1, 1913, when its fair market value as of that date is lower than its cost, the deductible loss is the excess of such fair market value over the amount realized therefor. No

> gain or loss is recognized in the case of property sold or exchanged (a) at more than cost but at less than its fair market value as of March 1, 1913, or (b) at less than cost but at more than its fair market value as of March 1, 1913. In any case proper adjustment must be made in computing gain or loss from the exchange or sale of property for any depreciation or depletion sustained and allowable as a deduction in computing net income; the amount of depreciation previously charged off by the taxpayer shall be deemed to be the true depreciation sustained unless shown by clear and convincing evidence to be incorrect. * * *

STATEMENT OF FACTS

The Board of Tax Appeals made the following findings of fact which are not in dispute (R. 39–40):

The three petitioners were for many years prior to 1922, and all during that year, partners in the firm of Bishop and Company. Each owned a one-third interest. In 1905 they purchased a tract of 6.24 acres of land lying along 8th Street, between Alameda and Lawrence Streets, in the city of Los Angeles, California. The purchase price was $94,610.74. In 1907 they put up a concrete building on the property at a cost of $94,134.19. In 1908 and 1909 other improvements were erected amounting to $5,543.73 and $21.92, respectively. The land and buildings were sold by the petitioners in 1922

for $500,000, the net to petitioners being $476,-179.90. Spur lines from two railroads ran to this land and it was the only available tract of any considerable size suitable for manufacturing purposes, and "close in" to the then business center of the city. At the time of its purchase and for some years thereafter, proximity to the business center was very desirable in a manufacturing site. The original purchase price in 1905 was approximately the fair value of the land, and by March 1, 1913, its value without improvements was $382,797.80. There is no evidence regarding the amount of depreciation upon the buildings.

About the year 1915 the real-estate market in Los Angeles went into a bad slump, and no recovery took place for five or six years. By 1922, however, the market had recovered at least its status of March 1, 1913, and by 1923 it reached its peak. But by that time large industrial sites "close in" were not in much demand, as factories had gone farther out to get cheaper land.

The contention of the petitioners is that the March 1, 1913, value of the property sold by them in 1922 was $466,132.27, and that the net taxable gain was only $10,047.63. The respondent determined the March 1, 1913, value to be $345,463.54, resulting in a net taxable gain of $152,901.39, or $50,967.13 to each partner. No other questions were presented.

The Board in its opinion held that the fair market value of the land as of March 1, 1913, was $382,797.80, and that the value of the buildings was the value as determined by the Commissioner, namely, the depreciated cost of the buildings as of March 1, 1913, and that the amount of taxable gain resulting from the sale of this property should be recomputed, based upon a value of $382,797.80 for the land, plus the depreciated value of the buildings as of March 1, 1913. (R. 41–42.)

On December 17, 1928, the Board entered its final orders of redetermination, computed as aforesaid, wherein it determined deficiencies against the petitioners, Joseph O. Koepfli, Roland P. Bishop, and William T. Bishop for the year 1922 in the amounts of $3,890.38, $2,665.53, and $2,696.94, respectively. The petitioners do not assign an error as to the March 1, 1913, value of the land, but only allege error on account of the reduction of the basis by depreciation accrued prior to March 1, 1913, amounting to $11,297.93. (R. 54–55.)

SUMMARY OF ARGUMENT

An adjustment of the cost basis of determining the gain from the sale of property acquired prior to March 1, 1913, may be required without any specific provision therefor in Section 202 (b) of the Revenue Act of 1921. In *United States* v. *Ludey*, 174 U. S. 295, it was recognized that depreciation sustained subsequent to March 1, 1913,

should be subtracted from the March 1, 1913, value of property which under the Revenue Act of 1916 was the basis for determining the gain from the sale of property acquired prior to that date.

The principle of the *Ludey decision* is applicable here. The reduction of the cost basis by depreciation sustained prior to March 1, 1913, is necessary to determine the true cost and thus to arrive at the full profit accrued subsequent to March 1, 1913.

There can be no constitutional objection to this theory and it has been adopted consistently in decisions of the Board in rulings of the Internal Revenue Bureau under the Revenue Act of 1921 and previous revenue acts. Congress in enacting Section 202 (b) (1) of the Revenue Act of 1921 without making any specific provision as to depreciation must be presumed to have acquiesced in this practice.

In the Revenue Act of 1924 Congress changed the rule as to depreciation but in the Revenue Act of 1926 it enacted into law the Bureau rule existing prior to the Revenue Act of 1924 and thus impliedly approved the construction given by the Bureau to Section 202 (b) (1) of the Revenue Act of 1921 in requiring adjustments for depreciation prior to March 1, 1913.

104130—30——2

ARGUMENT

I

In determining the gain realized in 1922 on the sale of property acquired prior to March 1, 1913, when the basis is cost, proper adjustment of the cost should be made for depreciation sustained between the date of acquisition and March 1, 1913

At the outset the attention of the court is called to the fact that the record does not adequately disclose the basis of the Board's redetermination of the tax liability as to the method actually used in determining the gain from the sale of the buildings as distinguished from the gain from the sale of the land.

The Board's findings of fact show that the Commissioner originally placed a market value, as distinguished from cost, of $345,463.54 as of March 1, 1913, on both land and buildings and that the petitioners asked for a determination of a fair market value as of March 1, 1913, of $466,132.27. (R. 40.)

The Board in its opinion stated that the land alone had a fair market value of $382,797.80 as of March 1, 1913, and that the taxpayer had failed to sustain the burden of proof as to the fair market value as of that date of the buildings alone. (R. 41.) In the last sentence of its opinion it directed that the gain from the sale of the property should be determined as follows (R. 42):

> The amount of taxable gain resulting from the sale of this property should be recomputed, based upon a value of $382,797.80 for the land plus the depreciated value of the buildings, all as of March 1, 1913.

From the use of the term "the depreciated value of the buildings, all as of March 1, 1913," it is not clear whether the Board directed the Commissioner to determine the March 1, 1913, basis as to the buildings by extrinsic evidence and in lieu of better evidence to determine the March 1, 1913, market value (as distinguished from cost) of the buildings by depreciated cost as of that date, or whether the Board instructed the Commissioner to reject entirely the basis of *market value* and use in lieu thereof the basis of *cost*, measuring the latter by the original cost as reduced by depreciation sustained prior to March 1, 1913.

The orders of redetermination do not disclose how the computation was made, but the statement of the method of determination set forth in the petition for review (R. 51–53) is correct. Under such circumstances there may be a doubt as to whether any question is raised in the record for determination by this court. Both the petitioners and the respondent, however, have proceeded on the theory that while the land was treated on the basis of value, the buildings were treated on the basis of cost, and that the question as to whether on the latter basis cost should be reduced by depreciation is properly here for review.

Section 202 (b) (1) of the Revenue Act of 1921, *supra*, provides that in determining the gain or loss from the sale of property acquired prior to March 1, 1913, the basis for measuring the gain or loss is

the cost or March 1, 1913, value, whichever is greater.

Applying that provision to the instant case the Board of Tax Appeals determined the gain from the sale of the land minus the improvements by using the fair market value as of March 1, 1913, which it found to be $382,797.80, an amount in excess of the original cost, $94,610.64. (R. 39, 40.) In determining the gain from the sale of the improvements, however, it found that the cost of the improvements (instead of the March 1, 1913, value) was the proper basis to be used and in measuring the gain reduced the cost by depreciation sustained prior to March 1, 1913, as well as by depreciation sustained between March 1, 1913, and the date of sale.

The petitioners do not raise any question as to the correctness of the Board's determination other than its reduction of the cost basis by depreciation sustained prior to March 1, 1913.

The petitioners argue that Section 202 (b) (1) of the Revenue Act of 1921 does not specifically provide for an adjustment in the cost basis for depreciation sustained prior to March 1, 1913, and that in requiring such an adjustment the respondent is attempting to read something into Section 202 (b) (1) that is not properly to be drawn from the provisions themselves and is indeed in conflict with them.

The respondent freely admits that none of the Revenue Acts prior to the Revenue Act of 1924 contained any specific provision for reducing either the basis of cost or the basis of the March 1, 1913, value by depreciation sustained or allowed either before or after March 1, 1913. The petitioners, however, have not denied that depreciation sustained subsequent to March 1, 1913, is a proper adjustment and the Supreme Court of the United States in *United States* v. *Ludey,* 274 U. S. 295, in a case arising under the Revenue Act of 1916 held that the requirement in that Act that the March 1, 1913, value of property be used as a basis in determining the gain from the sale should be construed as requiring deductions for both depreciation and depletion. While the *Ludey case* did not involve any question of depreciation and depletion sustained prior to March 1, 1913, it is authority for the principle that the reduction of the cost basis by depreciation may be required without specific provision therefor in the revenue act.

There can be no constitutional objections to the imposition of the tax on so much of the profit from the sale as results from the reduction of the cost basis by depreciation sustained prior to March 1, 1913. Congress may lawfully tax all gains arising from the sale of property in so far as they have accrued subsequent to March 1, 1913. *Merchants' L. & T. Co.* v. *Smietanka,* 255 U. S. 509; *Goodrich* v. *Edwards,* 255 U. S. 527; *Walsh* v. *Brewster,* 255

U. S. 536. It can not be said in this case that the respondent proposes to tax any gain accruing prior to March 1, 1913. On the contrary, under the respondent's theory and practice, the original cost is taken as the starting point and that basis is reduced by the amount of depreciation sustained and increased by the amount of improvements to determine the true cost as of March 1, 1913. The profit taxed is the difference between the true cost on March 1, 1913, and the selling price; that is, the entire profit actually accruing subsequent to March 1, 1913.

From an accounting standpoint there can be no question that in determining the actual gain from the sale of a depreciable asset the amount of the gain is the difference between the depreciated cost and the sale price. The theory of annual allowances for depreciation and of adjustments for depreciation in determining gain from the sale of property is well stated in the *Ludey case,* as follows (pp. 300–301):

> Congress, in providing that the basis for determining gain or loss should be the cost or the 1913 value, *was not attempting to provide an exclusive formula for the computation.* The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used. The amount of the

> allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost. *The theory underlying this allowance for depreciation is that by using up the plant, a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold. When the plant is disposed of after years of use, the thing then sold is not the whole thing originally acquired. The amount of the depreciation must be deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale of properties.* Any other construction would permit a double deduction for the loss of the same capital assets. (Italics supplied.)

Applying the reasoning of the *Ludey case* to the facts in the instant case it is clear that when the petitioners used the buildings here involved during the years prior to March 1, 1913, they were making a gradual sale of the buildings and on March 1, 1913, they did not own and could not sell the whole of the original buildings but they had and could sell only such portion as had not been disposed of through depreciation. Further "sales" of the property through depreciation were made subsequent to March 1, 1913, so that what they actually

sold in 1922 was the original buildings less the depreciation sustained from the date of acquisition in 1907.

Another analogy may be drawn which illustrates our position. If between 1907 and March 1, 1913, a part of one of the buildings had been destroyed by fire and had been compensated for in part by insurance it would scarcely be considered that in determining the gain from the sale no account should be taken of those facts and that the basis should be the original cost without adjustment. Depreciation operates in a similar way. If not regarded as a gradual sale of the property it may be regarded as a gradual physical destruction of the property.

It is our view that in prescribing a basis of "cost" in Section 202 (b) (1) of the Revenue Act of 1921, Congress, to quote the language of the *Ludey decision,* "was not attempting to provide an exclusive formula for the computation" and that to arrive at the true cost of the petitioners' buildings it is necessary to make an adjustment for depreciation sustained prior to March 1, 1913. This view finds support in the earlier decisions of the Board of Tax Appeals in *Appeal of Even Realty Co.,* 1 B. T. A. 355, and *Noaker Ice Cream Co.* v. *Commissioner of Internal Revenue,* 9 B. T. A. 1100. The reasoning on which it is based is well stated in the opinion of the Board in the *Even Realty Company case,* as follows (pp. 358, 364):

We have no hesitation in holding that Congress in using the word *basis* meant nothing but *starting point* or *primary figure* in the computation of gain or loss, and had no intention of restricting that computation to a simple subtraction of the basis from the selling price or vice versa. It expected the computation to include all adjustments necessary to a logical ascertainment of gain or loss. The only reason for using the word at all was to take care of the different situations arising when the property disposed of had been acquired (a) before and (b) on or after March 1, 1913. It fixed the starting point or primary figure of computation in the respective cases, but did not attempt to define every step of the computation under varying circumstances. In some cases, as when a taxpayer buys a security for one price and sells it for another, a simple subtraction is all that is necessary to determine his gain or loss. But, in other cases, either the basis or the sale price must be adjusted before making the subtraction in order to have the difference truly represent the gain or loss. For example: If a taxpayer owned property on March 1, 1913, then worth $10,000, thereafter made permanent improvements thereon at an expense of $5,000, and later sold it for $16,000, it is obvious that the difference between the $10,000 *basis* and the $16,000 sale price is not a proper measure of the gain from the transaction. If one bought land with timber upon it for

$10,000 in 1914, cut down the timber, and later sold the land for $11,000, his gain could not properly be computed without reference to the value realized by him in cutting the timber—and this would be true whether or not he had sold the timber, whether or not he had taken account of it on his books or in his tax returns, and whether or not he had claimed a deduction in his tax returns for depletion.

*   *   *   *   *

The same considerations that lead us to the conclusion that adjustment for recoveries of capital by allowance for exhaustion, wear and tear, and obsolescence must be made in computing gain upon the sale of property, compel us to the belief that similar adjustments should be made to cost before comparing it with value on March 1, 1913, for the purpose of deciding which of them should be the basis for that computation. If the taxpayer recovered a part of the cost of his property before March 1, 1913, only the balance of that cost can properly be recoverable thereafter. The Constitution certainly does not entitle a taxpayer to recover any part of his cost more than once, before becoming accountable for taxes upon his gain. If, after proper adjustment for partial recoveries, it appears that the cost exceeds the value at March 1, 1913, that adjusted cost rather than the March 1, 1913, value should be taken as the basis for all subsequent computations; if it be less than the

> March 1, 1913, value the latter is the proper basis. Thus, if a taxpayer in 1903 buys a building with a normal life of 20 years for $10,000, and recovers in rents one-half of that cost by 1913, he is entitled to recover thereafter through deductions or upon the sale of the property either $5,000 or the market value at March 1, 1913, whichever is higher. To allow more would be permitting him a double recovery of part of his capital investment before accounting for profit, and certainly the Constitution does not compel that.

The *Noaker Ice Cream Company case* decided by the Board after the decision of the Supreme Court in the *Ludey case* is an affirmation of the Board's decision in the *Even Realty Company case.*

The petitioners have cited as opposed to the Board's view the case of *Heiner* v. *Tindle,* 276 U. S. 582. That question was, it is true, involved in the record in the *Tindle case,* but it was not raised or considered either in the Supreme Court or the courts below. In these circumstances it can not be said to have been authoritatively decided. As was said in *United States* v. *Mitchell,* 271 U. S. 9, 14:

> It is not to be thought that a question not raised by counsel or discussed in the opinion of the court has been decided merely because it existed in the record and might have been raised and considered. *Webster* v. *Fall,* 266 U. S. 507, 511.

Moreover, the *Tindle case* was remanded to the District Court for the Western District of Pennsylvania for a determination of the loss derived from the sale of the property there involved, and it can not yet be said what computation will be made by the District Court. The cases of *Goodrich* v. *Edwards, supra; Walsh* v. *Brewster, supra; Lucas* v. *Alexander,* 279 U. S. 573; *United States* v. *Flannery,* 268 U. S. 98; and *McCaughn* v. *Ludington,* 268 U. S. 106. involve sales of bonds, stocks, and other property incapable of depreciation and can not be said to have established any rule with respect to adjustments for depreciation.

The only argument presented by the taxpayer that deserves serious consideration is that in the *Ludey case* the Court indicated in its opinion that where the March 1, 1913, value is used as a basis, the subsequent depreciation and depletion adjustments should be measured by the amounts allowable under the appropriate Revenue Acts. The petitioners contend that such a holding is equally applicable to cases where "cost" is the basis, and, if the property is acquired prior to March 1, 1913, there is a period between the time of acquisition and March 1, 1913, in which there were no Revenue Acts in force, and hence no allowable *depreciation.* It is recognized that there is force to this argument and that this precise point presented difficulty to the Board of Tax Appeals in the case of *Noaker*

Ice Cream Company, supra, as is indicated by the dissenting opinion concurred in by seven members of the Board upon which the petitioners rely. The majority opinion, however, sustains the respondent's position and for reasons previously stated it is believed that the Board's prevailing opinion presents the proper solution of the question. In that opinion it was said (p. 1103):

> Obviously, it was unnecessary in that case to consider depreciation or depletion which was sustained on cost prior to March 1, 1913, for the reason that cost was less than the March 1, 1913, value, and, therefore, when we have a selling price which exceeds either the cost or selling price, we need concern ourselves only with the higher of two, which in this case was the March 1, 1913, value. The reason which prompted the court to limit the depreciation and depletion to be deducted to that allowable as a deduction from 1913 to 1917 is not only explainable but is also entirely logical when we consider that the allowable depletion under the Revenue Act of 1913 was not on the basis of depletion sustained, but was limited to a percentage of the output of a mine. In any other manner it is difficult to see the necessity for making a distinction between "sustained" and "allowable" since when applied to depreciation the amount sustained in any one year could hardly be said not to be the reasonable allowance contemplated by the statute (ex-

cept under the 1913 Act applicable to individuals entitled to such a deduction on account of mining property).

It is further urged that it has been the established practice of the Internal Revenue Bureau under the Revenue Act of 1921 and prior Revenue Acts to reduce the cost basis by depreciation sustained prior to March 1, 1913. The petitioners so concede. (Br. p. 20.) While Article 1561 of Regulations 62, *supra,* does not specifically mention depreciation sustained prior to March 1, 1913, there were in effect during the years involved certain Bureau rulings supplemental to the regulations in which it was held that an adjustment for such depreciation should be made in determining the gain or loss from the sale of property. T. D. 3206, C. B. 5, p. 51; I. T. 1494, C. B. I–2, p. 19; A. R. R. 6930, C. B. III–1, p. 45. These rulings, adopted for the guidance of the administrative bureau charged with the enforcement of the act, are entitled to considerable weight. *Maryland Casualty Co.* v. *United States,* 251 U. S. 342; *National Lead Co.* v. *United States,* 252 U. S. 140. This is the more true since Congress, in enacting the Revenue Act of 1921 without making any express provision for depreciation, must be taken to have legislated with reference to the existing Bureau practice as set forth in T. D. 3206, *supra. National Lead Co.* v. *United States, supra.*

II

The legislative history of the enactment of Section 202 (b) (1) of the Revenue Act of 1921 does not show that in enacting that provision Congress intended that no adjustment for depreciation sustained prior to March 1, 1913, should be made in the cost basis

None of the Revenue Acts prior to the Revenue Act of 1924 contained any specific provision for a reduction of cost or March 1, 1913, value by depreciation whether sustained prior to or subsequent to March 1, 1913, nor was any discussion of the propriety of such deductions included in the House and Senate Reports under the Revenue Acts of 1913, 1916, 1918, or 1921.

The petitioners have referred to the Revenue Act of 1921 as containing changed provisions as to the computation of gain or loss from the sale of property acquired prior to March 1, 1913, and has attempted to draw from such changes an inference as to the intent of Congress relative to adjustments for depreciation.

A comparison of the corresponding provisions of the previous revenue acts with Section 202 (b) of the Revenue Act of 1921 shows conclusively the fallacy of this argument.

Section 2 (c) of the Revenue Act of 1916, c. 463, 39 Stat. 756, provides as follows:

> Sec. 2. (c) For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen

> hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived.

The Revenue Act of 1917 made no amendment of this provision.

Section 202 (a) of the Revenue Act of 1918, c. 18, 40 Stat. 1057, provides as follows:

> SEC. 202. (a) That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—
>
> (1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; and
> (2) In the case of property acquired on or after that date, the cost thereof; or the inventory value, if the inventory is made in accordance with section 203.

Section 202 (b) of the Revenue Act of 1921, *supra*, provides as follows:

> SEC. 202. (b) The basis for ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March 1, 1913, shall be the same as that provided by subdivision (a); but—
>
> (1) If its fair market price or value as of March 1, 1913, is in excess of such basis, the gain to be included in the gross income shall

be the excess of the amount realized therefor over such fair market price or value;

(2) If its fair market price or value as of March 1, 1913, is lower than such basis, the deductible loss is the excess of the fair market price or value as of March 1, 1913, over the amount realized therefor; and

(3) If the amount realized therefor is more than such basis but not more than its fair market price or value as of March 1, 1913, or less than such basis but not less than such fair market price or value, no gain shall be included in and no loss deducted from the gross income.

It will be noted that none of these sections contained any provision as to depreciation and that the change in the Revenue Act of 1921 had merely to do with the question of using cost or March 1, 1913, value as a basis. This change as appears clearly from H. R. No. 350, 67th Cong., 1st Session, p. 9 (cited on page 13 of petitioners' brief), and S. R. 275, 67th Cong., 1st Session, p. 10 (cited on page 14 of petitioners' brief) was made because of the decisions of the Supreme Court in the cases of *Merchants' L. & T. Co.* v. *Smietanka,* 255 U. S. 509; *Goodrich* v. *Edwards, supra;* and *Walsh* v. *Brewster, supra,* all of which related to sales of stocks and bonds rather than sales of depreciable property.

The questions involved in those cases had to do with such problems as whether a gain equivalent to the difference between selling price and fair

market value as of March 1, 1913, should be taxed when such value was less than cost. There is consequently nothing in the committee reports under the Revenue Act of 1921 which supports the petitioners' contention that Congress showed an intention to exclude depreciation deductions. On the contrary, as previously pointed out, Congress must be taken to have enacted the provision with notice of the practice of the Internal Revenue Bureau as set forth in T. D. 3206, C. B. 5, p. 51, amending Article 1561 of Regulations 45 as follows:

> ART. 1561. *Basis for determining gain or loss from sale.*—For the purpose of ascertaining the gain or loss from the sale or exchange of property the basis is the cost of such property, or if acquired on or after March 1, 1913, its cost or its approved inventory value. But in the case of property acquired before March 1, 1913, when its fair market value as of that date is in excess of its cost, the gain which is taxable is the excess of the amount realized therefor over such fair market value. Also in the case of property acquired before March 1, 1913, when its fair market value as of that date is lower than its cost, the deductible loss is the excess of such fair market value over the amount realized therefor. No gain or loss is recognized in the case of property sold or exchanged (a) at more than cost but at less than its fair market value as of March 1, 1913, or (b) at less than cost but at more than its fair market value as of March 1,

> 1913. In any case proper adjustment must be made for any depreciation or depletion sustained. * * *

The Revenue Act of 1924, c. 234, 43 Stat. 253, contains the following provision:

> Sec. 202. (b) In computing the amount of gain or loss under subdivision (a) proper adjustment shall be made for (1) any expenditure properly chargeable to capital account, and (2) any item of loss, exhaustion, wear and tear, obsolescence, amortization, or depletion, previously allowed with respect to such property.

Relative to this provision H. R. 179, 68th Cong., 1st Session, p. 12, shows the following:

> Sec. 202. (2) There is no provision in the existing law which corresponds to subdivision (b), but the rule laid down therein is substantially the same as the construction placed upon the existing law by the Treasury Department. It provides that in computing gain or loss from the sale or other disposition of property the cost or other basis of the property (and in the appropriate case the fair market value as of March 1, 1913) shall be increased by the amount of items properly chargeable to capital account and decreased by the depreciation and similar deductions allowed with respect to the property. Under this provision capital charges, such as improvements, and betterments, and carrying charges, such as taxes on unproductive prop-

> erty, are to be added to the cost of the property in determining the gain or loss from its subsequent sale, and items such as depreciation and obsolescence previously allowed with respect to the property are to be subtracted from the cost of the property in determining the gain or loss from its subsequent sale.

It is conceded that this report indicates that Congress thought it was enacting into law the existing departmental rule as to depreciation. In view of existing rulings which have been cited, however, such as T. D. 3206, I. T. 1494, and A. R. R. 6930, *supra,* which provide for adjustments for depreciation *sustained* prior to and subsequent to March 1, 1913, it is clear that Section 202 (b) of the Revenue Act of 1924, if construed as authorizing depreciation adjustments only to the extent that deductions for depreciation had been allowed in computing net income for previous years, represented a new rule. Obviously, either the Committee was misinformed as to the Departmental rule or in its comment it lost sight of depreciation sustained prior to March 1, 1913, and had in mind only depreciation sustained since that date, which in many cases is that actually charged off by the taxpayer and allowed as deductions. Cf. Article 1561 of Regulations 62, *supra.*

In enacting the Revenue Act of 1926, as is shown in H. R. 1, 69th Cong., 1st Session, pp. 5–6, and in S. R. 52, 69th Cong., 1st Session, pp. 16–16, Congress desired to change the provisions of the existing

law, that is, the Revenue Act of 1924, which authorized an adjustment only as to "depreciation allowed." Accordingly, for the first time the Bureau's rule as to adjustments for depreciation which existed prior to the Revenue Act of 1924 was incorporated in the law for the first time.

Section 202 (b) of the Revenue Act of 1926, c. 27, 44 Stat. 9, provides:

> SEC. 202. (b) In computing the amount of gain or loss under subdivision (a)—
>
> (1) Proper adjustments shall be made for any expenditure or item of loss properly chargeable to capital account, and
>
> (2) The basis shall be diminished by the amount of the deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion which have since the acquisition of the property been allowable in respect of such property under this Act or prior income tax laws; but in no case shall the amount of the diminution in respect of depletion exceed a depletion deduction computed without reference to discovery value or to paragraph (2) of subdivision (c) of section 204. In addition, if the property was acquired before March 1, 1913, the basis (if other than the fair market value as of March 1, 1913) shall be diminished in the amount of exhaustion, wear and tear, obsolescence, and depletion actually sustained before such date.

It is our view that in incorporating Section 202 (b) in the Revenue Act of 1926 Congress ex-

pressly repudiated the provision of the Revenue Act of 1924 and enacted into law the departmental practice existing before its enactment. That the Treasury Department, prior to the enactment of the Revenue Act of 1924, required an adjustment for depreciation sustained prior to March 1, 1913. identical with that required by Section 202 (b) of the Revenue Act of 1926 is conceded by petitioners. (Br. 10, 20.) In view of these concessions it is difficult to understand how it can be argued that Section 202 (b) of the Revenue Act of 1926 constitutes wholly new legislation.

The proper construction to place upon the enactment of Section 202 (b) of the Revenue Act of 1926 is that Congress clarified the law as it existed in the Revenue Act of 1921 and prior revenue acts and that its intention as to the proper construction of those acts (where depreciation adjustments were not specifically provided for) may be gathered from the language of Section 202 (b) of the Revenue Act of 1926.

As this court said in *United States* v. *Phez Co.* (C. C. A. 9th), 28 F. (2d) 106, at p. 107:

> If it can be gathered, from a subsequent statute in pari materia, what meaning the Legislature attached to the words of a former statute, it will amount to a legislative declaration of its meaning and will govern the construction of the first statute.

In the same connection see *Johnson* v. *Southern Pacific Co.,* 196 U. S. 1, 20–21, where the court said:

> As we have no doubt of the meaning of the prior law, the subsequent legislation can not be regarded as intended to operate to destroy it. Indeed, the latter act is affirmative, and declaratory, and, in effect, only construed and applied the former act.

CONCLUSION

In view of the foregoing the decision of the Board of Tax Appeals should be affirmed.

G. A. Youngquist,
Assistant Attorney General.
Sewall Key,
Helen R. Carloss,
Special Assistants to the Attorney General.

C. M. Charest,
General Counsel,
Bureau of Internal Revenue,
Dewitt M. Evans,
Special Attorney,
Bureau of Internal Revenue,
Of Counsel.

March, 1930.

U. S. G VERNMENT PRINTING OFFICE, 1930